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In the Supreme Court of the United States

OCTOBER TERM, 1975

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

STANDARD LIFE & ACCIDENT INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The memorandum opinion of the Tax Court (App. A, *infra*, pp. 1a-8a) is not officially reported. The opinion of the court of appeals (App. B, *infra*, pp. 9a-23a) is reported at 525 F.2d 786.

JURISDICTION

The judgment of the court of appeals (App. C, *infra*, pp. 24a-25a) was entered on November 6, 1975. The court of appeals denied a petition for rehearing with suggestion for rehearing *en banc* on January 9, 1976 (App. D, *infra*, pp. 26a-27a). By orders dated March 30 and April 26, 1976, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 6, 1976 (a Sunday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a life insurance company which reduces its federal tax liability by including in its "reserves" the net valuation portion of its deferred and uncollected premiums on the assumption that the full annual premiums on all of its outstanding policies have been paid on their anniversary dates, must either (A) include the full amount of its deferred and uncollected premiums in its "assets" and "gross amount of premiums" under Sections 805(b)(4) and 809(c)(1) of the Internal Revenue Code of 1954, or (B) exclude such premiums altogether in computing its "reserves," "assets" and "gross amount of premiums"; or whether, as the court of appeals held, it can exclude altogether its deferred and uncollected premiums from "assets" and "gross amount of premiums" but nevertheless include their net valuation portions in its "reserves."

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 801, 802, 804, 805, 809, 810, and 818 of the Internal Revenue Code of 1954, as amended (26 U.S.C.), and of Treasury Regulations, Sections 1.801-4, 1.805-5 and 1.809-4 (26 C.F.R.) are set forth in App. E, *infra*, pp. 28a-51a.

STATEMENT

Respondent is an Oklahoma stock corporation engaged in the business of issuing insurance. During 1958-1961, it qualified for preferential federal tax treatment as a "life insurance company" under Section 801(a) of the Internal Revenue Code of 1954. As a life insurance company, respondent was subject to supervision and audit by the Oklahoma Insurance Commissioner, as assisted by the National Association of Insurance Commissioners ("N.A.I.C.") (App. A, *infra*, pp. 2a-3a; App. B, *infra*, p. 10a).

Respondent receives income in the form of life insurance premiums. The "gross premium" is the amount actually charged an insured, and is equal to the sum of the "net valuation premium" and "loading." The "net valuation premium" equals the sum of money sufficient under applicable actuarial tables (based upon mortality and interest rate assumptions) to pay all death claims. Respondent was required under Oklahoma law to add this sum to its policy reserve each year. "Loading" is the amount added to the "net valuation premium" for agents' commissions and other acquisition costs, management and operat-

ing expenses, profits and dividends (App. B, *infra*, p. 10a).

Respondent's policyholders pay their premiums annually, or in semi-annual, quarterly, or monthly installments. When policyholders pay their premiums other than annually, "deferred premiums" are those portions of the gross annual premiums that become due after the end of each calendar year but before the next anniversary date of the policy. "Due and unpaid premiums" or "uncollected premiums" are premiums that are due and payable before the end of the calendar year but which have not been paid (App. B, *infra*, p. 11a).

Respondent's life insurance policies provide for a grace period of 31 days or longer for the payment of premiums, during which the policy is fully effective. The insured has no obligation to pay the deferred or due and unpaid premiums on his policy. However, the insurer has no obligation to continue the insurance coverage beyond the period for which premiums have been paid. Thus, non-payment causes the policy to lapse (App. B, *infra*, p. 11a).

Pursuant to Oklahoma law, respondent was required to compute its reserves on its policies on the assumption that the annual premiums had been paid as of the anniversary date of the policy, whether or not this was the case. For federal tax purposes, respondent included the net valuation portion of its "deferred and uncollected premiums"[1] in its "life

[1] For purposes of convenience, we employ the term "deferred and uncollected premiums" to include deferred premiums, and due and unpaid or uncollected premiums.

insurance reserves" for the purposes of Section 801 (b)(1) of the Internal Revenue Code of 1954. Respondent accordingly took these additions to its reserves into account in making the federal tax computations under Sections 805 and 809 of the Code (App. A, *infra*, p. 3a; App. B, *infra*, p. 11a).

On its income tax return for 1958, respondent did not include any amount for deferred and uncollected premiums in computing its "assets" under Section 805(b)(4). On its returns for 1959 and 1961, respondent included in its Section 805(b)(4) computation of assets only the net valuation portion (exclusive of loading) of its deferred and uncollected premiums. Similarly, in its Section 809(c)(1) computation of "gross amount of premiums" on its 1958, 1959, and 1961 returns, respondent included only the net valuation portion of its deferred and uncollected premiums[2] (App. A, *infra*, pp. 5a-6a; App. B, *infra*, pp. 11a-12a).

On audit, the Commissioner of Internal Revenue determined that respondent was required to include the gross amount of its deferred and uncollected premiums in "assets" and in "gross amount of premiums" under Sections 805(b)(4) and 809(c)(1),

[2] The courts below characterized respondent as having claimed "deductions for the increases in loading" in computing its gains from operations under Section 809 (App. A, *infra*, p. 6a; App. B, *infra*, p. 12a). By including only the net valuation portion of its deferred and uncollected premiums in its "gross amount of premiums," the effect was the same as if respondent deducted the loading portion from the Section 809 computation.

respectively (App. B, *infra*, p. 12a). He accordingly determined deficiencies against respondent for 1958, 1959, and 1961, of $25,974.93, $90,647.02, and $34,986.04, respectively (App. A, *infra*, p. 1a).[3] On the authority of its decision in *Bankers Union Life Insurance Co.* v. *Commissioner*, 62 T.C. 661, the Tax Court rejected respondent's contention that it did not have to include deferred and uncollected premiums in "assets" under Section 805(b)(4) (App. A, *infra*, p. 7a). It also rejected respondent's second contention that "some portion or all of those premiums may be excluded or deducted from [its] 'gain from operations' under section 809" (App. A, *infra*, p. 8a).

A divided court of appeals reversed. The court held that respondent was not required to include any portion of its deferred and uncollected premiums in "assets" and "gross amount of premiums" even though it took the net valuation portion of these premiums into account in its reserves for purposes of the Sections 805 and 809 computations. While the majority acknowledged that four courts of appeals had previously upheld the Commissioner's position (App. B, *infra*, pp. 13a-14a), it premised its conclusion on the fact that respondent "has no legal, enforceable right to collect any unpaid premiums * * *" (App. B, *infra*, p. 18a). In the court's view, "it is * * * obvious that unpaid premiums are not 'assets used by a company in carrying on a trade or business' and that they cannot have any 'viable' asset basis until

[3] The Commissioner's adjustments did not result in a deficiency for 1960.

collected" (*ibid.*). The court likewise concluded that the "gross amount of premiums" under Section 809(c)(1) "cannot extend to unpaid premiums in which a taxpayer has no legally enforceable right" (App. B, *infra*, p. 21a).

After observing that the issue "has been considered by four other Circuits, and in each instance * * * [those courts had] reached a conclusion contrary to the result reached by the majority * * *," the dissenting judge stated that he was "persuaded that the result reached by the Fourth, Fifth, Sixth and Seventh Circuits is the proper one" (App. B, *infra*, p. 22a).

REASONS FOR GRANTING THE WRIT

1. In holding that a life insurance company could reduce its federal tax liability by including the net valuation portion of its deferred and uncollected premiums in its reserves on the assumption that the annual premiums on its policies have been paid on their anniversary dates but nevertheless exclude such premiums from "assets" and "gross amount of premiums" under Sections 805(b)(4) and 809(c)(1) of the Code, the court of appeals acknowledged (App. B, *infra*, pp. 13a-14a) that its decision directly conflicts with decisions of four other circuits. See *Franklin Life Insurance Co.* v. *United States*, 399 F.2d 757 (C.A. 7), certiorari denied, 393 U.S. 1118; *Jefferson Standard Life Insurance Co.* v. *United States*, 408 F.2d 842 (C.A. 4), certiorari denied, 396 U.S. 828; *Western National Life Insurance Co. of Texas* v. *Commissioner*, 432 F.2d 298 (C.A. 5);

Western and Southern Life Insurance Co. v. *Commissioner*, 460 F.2d 8 (C.A. 6), certiorari denied, 409 U.S. 1063. See also *Great Commonwealth Life Insurance Co.* v. *United States*, 491 F.2d 109 (C.A. 5).

The question is of great fiscal importance. The proper tax treatment of deferred and uncollected premiums affects every life insurance company and has the largest revenue impact of all of the issues currently being litigated under the Life Insurance Company Income Tax Act of 1959. We are advised by the Internal Revenue Service that it estimates the total amount of tax put in dispute by the decision below with respect to the exclusion of deferred and uncollected premiums from "assets" of those life insurance companies within the jurisdiction of the Tenth Circuit and the six remaining circuits that have not yet spoken on this issue to be substantially more than $100 million for the years 1972 through 1974 alone.[4]

[4] The Internal Revenue Service advises that nine of the ten largest life insurance companies are within the jurisdiction of the circuits in which the question of the proper tax treatment of deferred and uncollected premiums is open. Its revenue estimates are based upon industry-wide statistics as set forth in Institute of Life Insurance, *Life Insurance Fact Book* (1975).

There are 37 refund suits by 28 life insurance companies currently pending in the Court of Claims (which has not yet spoken to the issue) and the district courts involving the question of the proper tax treatment of deferred and uncollected premiums, which involve a total of $75,284,067. Of this amount, $81,572 is involved in a refund suit pending in a district court within the Fifth Circuit, which has upheld the Commissioner's position.

The substantial revenue impact of this decision is not limited to this three-year period because the tax years of most life insurance companies from 1958 [5] have remained open by agreement with the Internal Revenue Service. This Court should resolve the conflict and uncertainty created by the decision below and establish a national rule for the benefit of both the life insurance industry and the government alike.

2. a. The Life Insurance Company Income Tax Act of 1959, as set forth in Sections 801-820 of the Internal Revenue Code of 1954, provides a three-phase procedure for the taxation of life insurance companies. The primary categories of income subject to tax are "taxable investment income" (as defined in Section 804) and "gain from operations" (as defined in Section 809). "Taxable investment income" is, as the term implies, income from interest, dividends, and the like. "Gain from operations" is a broader category encompassing total net income from all sources, *i.e.*, taxable investment income plus other income, principally underwriting income.

[5] Section 4 of the Life Insurance Company Income Tax Act of 1959, 73 Stat. 141, makes the Act applicable to all tax years beginning after December 31, 1957.

We are advised by the Internal Revenue Service that three of the ten largest insurance companies have cases pending before the Court of Claims involving this issue for periods beginning with the year 1958. They are: Prudential Life Insurance Co. (1958-1964), John Hancock Life Insurance Co. (1958-1965) and Aetna Life & Casualty Co. (1958-1960). The Internal Revenue Service further advises that of the seven remaining such companies, six have all of their years from 1958 pending administratively or have time remaining in which to file a claim for refund.

Pursuant to Section 802(b), the total tax base of a life insurance company to which the ordinary corporate rates are applied is the sum of the tax bases derived from computations under each of the three phases. The Phase I tax base (Section 802(b)(1)) is the smaller of "taxable investment income" or "gain from operations." The Phase II tax base is equal to 50 percent of the excess, if any, of the gain from operations over taxable investment income (Section 802(b)(2)). Since "gain from operations" is a broader category comprising the company's net income from all sources, the sum of the Phase I and II tax bases can be alternatively described as the company's "gain from operations" up to the amount of its "taxable investment income" plus 50 percent of the excess over "taxable investment income." Finally, the deferred portion of underwriting income that is not taxed under Phase II becomes the Phase III tax base when such income is made available to shareholders (Section 815). See *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235 n. 2.

For purposes of the Phase I and II tax bases, the determination of the total tax base involves a series of computations directed toward arriving at the fundamental categories of "taxable investment income" [6] and "gain from operations." Like the earlier tax stat-

[6] There is a slight variation between the Phase I and II methods of computing "taxable investment income." However, that difference is not relevant for present purposes.

utes,[7] the 1959 Act recognizes that life insurance companies are required to maintain policyholder reserves to meet future claims and that the annual increments to the reserves should be free of tax. Section 801(b)(1) of the Code defines life insurance reserves and the statutory scheme provides a method for establishing the amount which, for tax purposes, is deemed to be added each year to these reserves.

Accordingly, the computations of both "taxable investment income" and "gain from operations" provide a statutory mechanism for excluding from the total tax base those portions of investment and underwriting income which must be added to the reserves. The payment of premiums necessarily results in the creation and funding of reserves that the company must invest. Thus, as the reserves and the amount of income necessary to fund the reserves in-

[7] The concept that a tax should be levied on net investment income but after an allowance to meet obligations to policyholders was first embodied in the Revenue Act of 1921, c. 136, Sections 242-247, 42 Stat. 261-264. It was carried forward in subsequent Acts dealing with insurance company taxation, although various formulae were used in computing the amount of the reserve exclusion. See Revenue Act of 1924, c. 234, Section 245(a), 43 Stat. 289-290; Revenue Act of 1926, c. 27, Section 245(a), 44 Stat. 47-48; Revenue Act of 1928, c. 852, Section 203(a), 45 Stat. 842-844; Revenue Act of 1932, c. 209, Section 203(a), 47 Stat. 224-225; Revenue Act of 1934, c. 277, Section 203(a), 48 Stat. 732-733; Revenue Act of 1936, c. 690, Section 203(a), 49 Stat. 1710-1711; Revenue Act of 1938, c. 289, Section 203(a), 52 Stat. 523-524; Internal Revenue Code of 1939, Section 203(a), 26 U.S.C. (1952 ed.) 203(a).

crease, the federal tax base will correspondingly decrease. Simply stated, the greater the reserves, the smaller the tax base.

(1) *Taxable Investment Income.* With respect to determining "taxable investment income," the statutory computations are generally directed toward dividing the investment income for the taxable year between a nontaxable "policyholders' share" deemed necessary for policyholder reserve obligations and a taxable "life insurance company's share." This is accomplished by dividing the company's "investment yield" [8] by the "assets" of the company [9] to produce an earnings rate. This rate, after adjustment,[10] is then multiplied by the company's adjusted life insurance reserves for policyholders.[11] The resulting prod-

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[8] Section 804(c) defines "investment yield" as "gross investment income," less specified deductions, including investment expenses, real estate expenses, depreciation and trade and business expenses, subject to certain exceptions and limitations.

[9] Section 805(b)(4) defines "assets" as "all assets of the company * * * other than real and personal property (excluding money) used by it in carrying on an insurance trade or business."

[10] The adjusted earnings rate equals the current earnings rate, or the average of the current earnings rate and the rates from the four years prior to the current rate, whichever is lower. See Section 805(b)(1), (2) and (3).

[11] Adjusted life insurance reserves are the company's life insurance reserves for policyholder obligations, adjusted for the difference between the assumed interest rate used by the company in computing the reserves and the actual earnings

uct is the exclusion from taxes for the amounts of investment income that must be added to life insurance reserves.

The foregoing computation may be expressed in the following formula:

$$\frac{\text{Investment yield}}{\text{Assets}} = \text{Earnings Rate}$$

$$\text{Earnings Rate (Adjusted)} \times \text{Reserves (Adjusted)} = \text{Tax Exclusion}$$

This formula graphically demonstrates that as assets increase, the earnings rate and the tax exclusion will decrease. However, as "reserves" increase, the tax exclusion will also increase. See *Western National Life Insurance Co. of Texas* v. *Commissioner*, *supra*, 432 F.2d at 300.

(2) *Gain from Operations.* The company's "gain from operations" includes its income from all sources less certain specified deductions. Since "gain from operations" includes the previous element of "taxable investment income," the computation of "gain from operations" is directed toward taking into account income from other sources, principally underwriting income. Underwriting gains result when the premium charged for a policy is in excess of the costs to the company for providing the coverage. Thus, in addi-

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rate. The reserve is reduced by 10 percent for every 1 percent by which the applicable earnings rate exceeds the company's assumed interest rate. To the amount so calculated are added pension plan reserves multiplied by the current earnings rate and interest paid during the taxable year. See Section 805(b), (c) and (d); *United States* v. *Atlas Life Ins. Co.*, *supra*, 381 U.S. at 236 n. 4.

tion to its taxable share of investment income, the items taken into account include the "gross amount of premiums," decreases in certain reserves, and other amounts (Section 809(c)).

The specified deductions (Section 809(d)) include non-investment expenses, such as underwriting expenses, salaries, and general overhead, and claims paid. In accord with the congressional decision to exclude policyholder reserves from the tax base, Section 809(d)(2) permits a deduction for increases in reserves during the taxable year. When the various deductions are subtracted from the company's gross income from all sources, the resulting figure is the "gain from operations."

Since "gross amount of premiums" is an income item in the above computation, increases in that element will result in a greater figure for "gain from operations" and a higher tax base. Conversely, since "increases in reserves" is a deduction item, increments to that statutory element will decrease the tax base.

b. Many of respondent's policyholders pay their premiums in semi-annual, quarterly, or monthly installments. Despite the fact that it had not received the full amount of the premiums as of the anniversary dates of these policies, respondent computed its reserves for federal tax purposes on the assumption that the full amounts of the "deferred and uncollected premiums" had been paid as of those dates. It therefore added to its reserves the net valuation premiums attributable to these deferred and uncollected

premiums, *i.e.*, the amount necessary under the applicable mortality tables that, together with interest, will provide the benefits under the policies. The court of appeals held that respondent was not required to include the deferred and uncollected premiums in "assets" (Section 805(b)(4)), relative to the "taxable investment income" computation, or in "gross amount of premiums" (Section 809(c)(1)), relative to the "gain from operations" computation.

The impact of this ruling upon each of the statutory computations is two-fold. With respect to the computation of "taxable investment income," the formula (p. 13, *supra*) demonstrates that the exclusion of the deferred and uncollected premiums from "assets" will result in a higher earnings rate and a greater tax exclusion. The inclusion of the deferred and uncollected premiums in "reserves" likewise results in a greater tax exclusion. Similarly, with respect to the computation of "gain from operations," exclusion of deferred and uncollected premiums from the income item "gross amount of premiums" and inclusion of the reserves attributable to such premiums in the deduction item "net increases in reserves" will result in a lower figure for "gain from operations."

Thus, the exclusion by the court of appeals of the deferred and uncollected premiums from "assets" and "gross amount of premiums" while including them in "reserves" produces a substantial narrowing of the Phase I and II tax bases of a life insurance company.

3. The fundamental error of the court of appeals is that it relied upon a contradictory set of assumptions concerning deferred and uncollected premiums. Those premiums, as the court observed (App. B, *infra*, pp. 11a, 18a n. 4), had not actually been paid to respondent during the taxable year and respondent had no legal right to compel their payment. But in approving respondent's inclusion of the net valuation premiums attributable to the deferred and uncollected premiums in its "reserves" for tax purposes, the court assumed that those premiums had been paid during the taxable year as of the anniversary dates of the policies. However, in holding that the deferred and uncollected premiums could be excluded from "assets" and "gross amount of premiums," the court made the contrary assumption that these premiums had not in fact been paid during the taxable year.

A life insurance company cannot have it both ways under the statute. It cannot first treat its deferred and uncollected premiums as having been paid during the taxable year for purposes of including them in "reserves" and thereby reduce its tax base, and then turn around and assert that it has not received the identical premiums for purposes of the "assets" and "gross amount of premiums" computations. The decision below improperly assumes that the deferred and uncollected premiums have been paid and have not been paid during the taxable year. As the Fourth Circuit succinctly put it in *Jefferson Standard Life Insurance Co.* v. *United States*, *supra*, 408 F.2d at 856, "Symmetry would require * * * that both sides of the

equation by which taxable income is determined be treated alike. Thus, if taxpayer treats its reserve liabilities for tax purposes with a full year's net valuation * * * it should be required to include gross annual premiums * * *." Accord: *Franklin Life Insurance Co.* v. *United States*, 399 F.2d 757 (C.A. 7), certiorari denied, 393 U.S. 1118; *Western National Life Insurance Co. of Texas* v. *Commissioner*, 432 F.2d 298 (C.A. 5); *Western and Southern Life Insurance Co.* v. *Commissioner*, 460 F.2d 8 (C.A. 6), certiorari denied, 409 U.S. 1063; *Great Commonwealth Life Insurance Co.* v. *United States*, 491 F.2d 109 (C.A. 5).

The court of appeals attempted to refute the analyses of the four circuits that have upheld the Commissioner's position on the ground that here respondent was required by Oklahoma law to establish reserves for each of its policies. From this premise, the court concluded that while "the reserves actually exist as a liability, the unpaid premiums do not exist until actually paid" (App. B, *infra*, p. 14a). In its view, the net valuation portions of the deferred and uncollected premiums were therefore required to be included in respondent's reserves while such premiums could not be included in its "assets" and "gross amount of premiums."

But the state law applicable in each of the appellate decisions upholding the Commissioner's position was identical to the Oklahoma law to which respondent was subject. At all events, this reasoning overlooks the critical fact that the reserves of a life insur-

ance company are not bookkeeping entries created in a vacuum. They represent liabilities to the policyholders only to the extent that the policyholders pay premiums out of which the reserves can be funded. See *New York Life Ins. Co.* v. *Edwards*, 271 U.S. 109, 119. Thus, to the extent that state law required respondent to include the net valuation portion of its deferred and uncollected premiums in the computation of its reserves, that state law requirement is based on the selfsame assumption upon which the Commissioner's position rests, *viz.*, that all of the premiums have been paid as of the anniversary dates of the policies.

In sum, the state law to which respondent is subject cannot justify the contradictory set of assumptions upon which the decision below is based. If the net valuation portions of the deferred and uncollected premiums are deemed to be paid for purposes of inclusion in the reserves, they must likewise be deemed to be part of the company's "assets" and "gross amount of premiums." Accord: Treasury Regulations, Sections 1.805-5 and 1.809-4, Appendix E, *infra*, pp. 48a-51a. Conversely, if the deferred and uncollected premiums are not deemed to be part of the company's "assets" and "gross amount of premiums," the net valuation portion of such premiums cannot be included in its reserves. Accord: Treasury Regulations, Section 1.801-4(f), App. E, *infra*, pp. 47a-48a. The touchstone of these Treasury Regulations, which the court of appeals erroneously invalidated (App. B, *infra*, pp. 17a, 21a), is that the tax treatment of deferred and uncollected premiums must adhere to a consistent set of assumptions—either those premiums are deemed to be paid for all purposes or deemed not to be paid for any purpose.

4. The unsoundness of the decision below is further demonstrated by the fact that the position of the life insurance industry has never gone as far as the approach adopted by the court of appeals. In all of the litigation to date under the Life Insurance Company Income Tax Act of 1959, the industry has not contended that the deferred and uncollected premiums could be excluded in their entirety from "assets" and "gross amount of premiums" under Section 805(b)(4) and 809(c)(1). To the contrary, the life insurance industry has acknowledged that the deferred and uncollected premiums are includable in "assets" and "gross amount of premiums," at least to the extent of the net valuation portion of those premiums.

The industry's position is shown by the sequence of events in *Western National Life Insurance Co. of Texas* v. *Commissioner*, *supra*. There, the Tax Court originally held, in conformity with the decision below in this case (50 T.C. 285, 297-300), that the entire amount of deferred and uncollected premiums was excludable from "assets." However, on the Commissioner's motion for reconsideration, the Tax Court modified its decision and adopted the position of the American Life Convention and the Life Insurance Association as *amici curiae* that deferred and uncollected premiums were includable in "assets" only to the extent of the net valuation portion of those pre-

miums (51 T.C. 824). While the Fifth Circuit reversed the Tax Court and upheld the Commissioner's position that the full amount of the deferred and uncollected premiums was includable in "assets," it noted that the Tax Court's holding was in conformity with the industry's views (see 432 F.2d at 301).[12]

The disparity between the life insurance industry's position and that of the court of appeals shows the radical nature of the decision below. While the industry's position is not as financially beneficial to the life insurance company as the ruling of the court of appeals, its approach suffers from the same contradictory set of assumptions as the decision below.

If a life insurance company assumes that the deferred and uncollected premiums on all of its policies have been paid as of their anniversary dates and increases its reserves for tax purposes by the net valuation portion of such premiums, that assumption necessary stands on the hypothesis that the company has received the full amount of those premiums and not some lesser amount. Thus, four circuits have correctly held that it is the gross amount of premiums that must be taken into account in the tax computations. In this respect, the language of Section 809(c)(1)—"gross amount of premiums"—refutes the in-

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[12] After four circuits had rejected its modified decision in *Western National Life Insurance Co.* (51 T.C. 824), the Tax Court subsequently upheld the Commissioner's position in *Bankers Union Life Insurance Co.* v. *Commissioner*, 62 T.C. 661. Its holding here was on the authority of that latter decision (App. A, *infra*, pp. 7a-8a).

dustry's contention that the deferred and uncollected premiums are includable in the tax computations only on a net valuation basis.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

STUART A. SMITH,
Assistant to the Solicitor General.

GILBERT E. ANDREWS,
ERNEST J. BROWN,
GARY R. ALLEN,
Attorneys.

JUNE 1976.

APPENDIX A

T. C. Memo. 1974-242

UNITED STATES TAX COURT

Docket No. 4132-71

STANDARD LIFE AND ACCIDENT INSURANCE CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Filed September 18, 1974

Gene A. Castleberry, for the petitioner.

Thomas J. Miller, for the respondent.

MEMORANDUM OPINION

TIETJENS, *Judge*: The Commissioner determined the following deficiencies in and additions to petitioner's income taxes:

Year	Deficiency	Section 6653(a) Additions to Tax
1958	$25,974.93	$1,298.75
1959	90,647.02	4,532.35
1961	34,986.04	1,749.30

The questions for decision are: (1) Whether deferred and uncollected premiums, including loading, and due and unpaid premiums, including loading, must be included in calculating petitioner's assets as

defined by section 805;[1] (2) Whether either those premiums or the increase in the loading portions thereof must be included in petitioner's gross underwriting income in determining its gain from operation under section 809; and (3) Whether petitioner may amortize the cost of blocks of cancellable health and accident insurance policies purchased from other insurance companies.[2]

This case was fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure. The facts which we deem necessary for decision will be referred to below.

Petitioner is, and at all times material hereto has been, a life insurance company as defined in section 801(a), with its home office and principal place of business in Oklahoma City, Oklahoma. Petitioner filed its federal income tax returns (Forms 1120L) for the calendar years 1958, 1959, 1960, and 1961 with the district director of internal revenue at Oklahoma City, Oklahoma.

In Bankers *Union Life Insurance Co.*, 62 T.C. —— (August 21, 1974), we defined certain terms common to the life insurance industry. We rely on those definitions in our discussion of the relevant facts of the instant case.

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[1] All statutory references are to the Internal Revenue Code of 1954, unless otherwise stated.

[2] In its brief, petitioner says it is not presenting the issue, raised in its petition, of whether agent's debit balance must be included in assets as defined by section 805. Accordingly, we do not consider it.

Petitioner is a stock life insurance company organized and existing under the laws of the State of Oklahoma. Its operations and accounts are subject to the supervision and approval of the Insurance Commissioner of the State of Oklahoma and, because it does business in numerous states, it is subject to periodic audit of its accounts by the National Association of Insurance Commissioners (hereafter NAIC) which acts on behalf of the insurance departments of the various states.

Petitioner was required by the State of Oklahoma and by the NAIC to compute its reserves on the great majority of its life insurance policies on the assumption that premiums were paid up one year in advance on each anniversary date commencing with the issuance date of the policy, even though premiums were not usually paid in this manner. The reserves so computed were reflected as a liability of petitioner and, as required by the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, were taken into account in the computations required under sections 805 and 809 on the federal income tax returns filed by petitioner for the taxable years 1958 to 1961, inclusive.

The increases and decrease in loading for each of the years involved were as follows:

1958	—	$ 65,308
1959	—	301,252
1960	—	(140,372)
1961	—	72,139

Relevant deferred and uncollected premiums (including loading) and due and unpaid premiums (including loading) were as follows:

Year	Deferred & uncollected premiums	Due and unpaid premiums
1957	$ 621,413	$118,047
1958	834,331	266,323
1959	1,314,987	253,318
1960	1,570,193	232,651
1961	1,572,763	231,969

The NAIC annual statement [3] treats deferred and uncollected premiums on a net basis. On the assets page of the balance sheet, the statement provides space for the entry of "Life Insurance premiums and annuity considerations deferred and uncollected." In detailing the assets, the statement provides for setting forth deferred and uncollected premiums on a net basis and provides for a memorandum account to show the amount of loading excluded from the deferred and uncollected premiums. On the liabilities page of the balance sheet, the statement provides space for the entry of the " 'Cost of collection' on premiums and annuity considerations deferred and uncollected in excess of total loading thereon." In conformity with the NAIC annual statement, petitioner's annual statements for 1958, 1959, 1960, and

[3] In its requested findings of fact, petitioner refers to the form it used for its annual statements as the "NAIC annual statement." The Commissioner does not object to that reference.

1961 showed net premiums deferred and uncollected as an asset. Also in conformity with the form, petitioner's annual statement did not show loading as an asset.

In the "Summary of Operations" contained in the NAIC annual statement, "Premiums and annuity considerations" includes deferred and uncollected premiums at gross to be added to gross premiums collected during the year less deferred and uncollected premiums at gross as of the end of the previous year. In that summary, the "Increase in aggregate reserve for policies and contracts with life contingencies" removes from income the net portion of the deferred and uncollected premiums. Also in that summary, the NAIC statement provides for the deduction of the increase in loading on deferred and uncollected premiums and also for the deduction of cost of collection of premiums in excess of loading on deferred and uncollected premiums. The deduction for increase in loading on deferred and uncollected premiums was claimed by petitioner on its federal income tax returns in determining its net gain from operations.

On its income tax return for the taxable year 1958, petitioner did not include any amount for deferred and uncollected premiums and due and unpaid premiums in computing its assets under section 805. On its returns for the years 1959 and 1961, petitioner included in its computation of assets only the net valuation premiums (exclusive of loading) with respect to its deferred and uncollected premiums and

due and unpaid premiums. On its returns for 1958, 1959, and 1961, petitioner claimed deductions for the increases in loading in computing its gains from operations under section 809.

On October 31, 1957, the petitioner purchased a block of insurance policies from United Founders Life Insurance Company for a net cost of $219,-524.21. On April 1, 1958, the petitioner purchased a block of insurance policies from Commonwealth Life Insurance Company at a net cost of $247,098.22. On October 1, 1960, the petitioner purchased a block of insurance policies from Great Western Life Insurance Company at a net cost of $77,280.29. The policies were accident and health and hospitalization policies and were all of the type generally referred to as "cancellable." "Cancellable" does not mean that the company could terminate a policy in midterm, but rather that it could refuse to renew any policy at the end of its stated term, for the policies were renewable at the option of the company.

On petitioner's income tax return for the years in issue, petitioner deducted as expenses in the years paid the current costs of the purchases of the blocks of insurance. Because the costs of these blocks of insurance were expensed in the years incurred, the petitioner did not cull and collate records sufficient to show either persistency of individual policyholders, premiums paid, or claims as they pertained to particular blocks of policies. Beginning in 1963, however, the petitioner kept its records by computer and thereby achieved the ready capacity to show premium

income received and claims paid by particular blocks of policies, including the three blocks here involved.

At the time of the purchase of each block of policies the Annualized Premium in Force (the total amount of premiums which would be received if every policyholder paid the premiums on his policy as they came due during the 12-month period following the date of the purchase contract) for each block was as follows:

Block	United Founders	Commonwealth	Great Western
Date	10/31/57	4/1/58	10/1/60
APIF	$468,156	$1,036,042	$301,959

From 1963 through 1972 the actual premiums received and claims paid during each year were as follows:

Year End	United Founders		Commonwealth		Great Western	
	Premiums	Claims	Premiums	Claims	Premuims	Claims
1963	$39,307	$26,719	$37,127	$22,390	$81,358	$51,098
1964	35,697	25,948	34,958	24,834	68,580	38,190
1965	26,414	17,854	31,737	17,183	56,923	29,861
1966	20,181	13,965	26,168	12,126	43,602	24,180
1967	16,847	8,779	20,612	11,680	29,002	18,216
1968	15,554	10,681	17,759	7,901	22,288	13,431
1969	14,020	10,124	15,775	7,204	17,846	8,320
1970	12,836	10,123	14,095	6,238	15,887	11,741
1971	11,685	9,836	12,114	6,569	13,618	10,024
1972	10,539	5,328	10,860	6,898	12,551	6,544

Petitioner's argument that it need not include in "assets" under section 805 deferred and uncollected premiums and due and unpaid premiums must fail on the authority and reasoning of *Bankers Union Life Insurance Co.*, 62 T.C. —— (August 21, 1974).

Similarly, on that authority and reasoning, we reject petitioner's second contention that some portion or all of those premiums may be excluded or deducted from petitioner's "gain from operations" under section 809.

The Commissioner determined that no portion of the cost of acquiring the blocks of cancellable accident and health policies was deductible. The petitioner argues that those costs are amortizable under section 1.167(a)-3 simply because the assets are wasting. On the authority of *International Life Insurance Co.*, 51 T.C. 765, 773 (1969), affd. per curiam 427 F.2d 137 (C.A. 6, 1970), we must reject petitioner's argument and hold for the Commissioner. Petitioner has not convinced us that that case is distinguishable or that it was incorrectly decided.

Decision will be entered for the respondent.

APPENDIX B

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

No. 75-1075

STANDARD LIFE & ACCIDENT INSURANCE COMPANY, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

Appeal from the Judgment of the
United States Tax Court
(No. 4132-71)

Gene A. Castleberry, Oklahoma City, Oklahoma, for Appellant.

Meade Whitaker and Gary R. Allen, Attorneys, Tax Division, Department of Justice, Washington, D.C. (Scott P. Crampton, Assistant Attorney General, Washington, D. C., Gilbert E. Andrews and Bennet N. Hollander, Attorneys, Tax Division, Department of Justice, Washington, D.C., on the Brief) for Appellee.

Before HOLLOWAY, MCWILLIAMS and BARRETT, Circuit Judges.

BARRETT, Circuit Judge.

Standard Life & Accident Insurance Company (taxpayer) appeals a Tax Court decision [1] which upheld the Commissioner's deficiency determination against taxpayer for the years 1958, 1959 and 1961. A recitation of the pertinent facts, which were fully stipulated to, will facilitate our review.

Taxpayer, an Oklahoma corporation, is a life insurance company as defined by the Internal Revenue Code, 26 U.S.C.A. §§ 801-820. Taxpayer's operations are subject to regulations adopted by the Insurance Commissioner of Oklahoma. It is further subject to periodic audit by the National Association of Insurance Commissioners (NAIC), which acts on behalf of the insurance departments of the various states.

Taxpayer receives income in the form of premiums which are the agreed price for assuring and carrying a particular risk. The "gross premium" is the amount actually charged an insured. It includes the "net valuation premium" and "loading". The "net valuation premium" equals that sum of money necessary under applicable mortality tables to provide the benefits of the policy. This sum is required by Oklahoma law to be added to the policy reserve each year. "Loading" is that amount added to the "net valuation premium" for acquisition, management, and operating expenses, profits, and dividends.[2] Policyholders pay their premiums in semi-annual, quarterly, or monthly installments.

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[1] T.C. Memo, 1974-242, Filed September 18, 1974.

[2] Loading is based on an independent judgment of each company.

"Deferred premiums" are premiums due on policies with installment payments. They become due after December 31st of each calendar year but before the anniversary date of the policy. "Due and unpaid premiums" or "uncollected premiums" are premiums which are due and payable before the end of the year but which have not been paid. These policies have a 31-day grace period, or longer, for the payment of premiums, during which the policy is carried in full force and effect. *There is no obligation, legal or otherwise, on an insured to pay the insurer taxpayer deferred, due and unpaid or uncollected premiums. Non-payment merely causes the policy to lapse.*

Taxpayer is required by the State of Oklahoma and the NAIC to compute its reserves on the majority of its policies as though all premiums are paid up one year in advance of the policy's anniversary date, even though, in actuality, this is generally not the case. These reserves are treated as a liability to an insurance company and considered in making computations under 26 U.S.C.A. §§ 805 (assets) and 809 (gain from operations) of the Life Insurance Company Income Tax Act of 1959.

In filing its tax return for 1958 taxpayer did not include any amount of deferred and uncollected or due and unpaid premiums in computing its assets under Section 805. In filing its return for 1959 and 1961, taxpayer included in its assets only the net valuation premiums (loading was excluded) with respect to its deferred and uncollected and due and unpaid, premiums. Furthermore, in 1958, 1959 and

1961, taxpayer also claimed deductions for the increases in loading in computing its gains from operations under Section 809.

On October 31, 1957, taxpayer purchased a block of insurance policies from United Founders Life Insurance Company at a net cost of $219,524.21. Thereafter, taxpayer purchased a block of insurance policies from Commonwealth Life Insurance Company at a net cost of $247,098.22. On October 1, 1960 taxpayer also purchased a block of insurance policies from Great Western Life Insurance Company at a net cost of $77,280.29. On its respective returns, taxpayer deducted as expenses in the years paid, the current costs of the purchase of the blocks of insurance.

The Commissioner held that deferred and uncollected, and due and unpaid premiums must be included under Section 805 as assets and that none of said premiums may be deducted in determining gain from operations under Section 809. The Commissioner also ruled that no portion of the acquisition costs of the blocks of insurance bought in 1957, 1960 and 1961 was deductible.

On de novo review, the Tax Court relied upon Bankers Union Life Insurance Co., 62 T.C. 661 (1974), in holding that deferred and uncollected premiums and due and unpaid premiums must be considered assets and that the premiums could not be excluded from taxpayer's gain from operation under Section 809. The Tax Court relied upon International Life Insurance Co. v. Commissioner of Internal Reve-

nue, 51 T.C. 765, 773 (1969), affirmed per curiam, 427 F.2d 137 (6th Cir. 1970), in its holding that no portion of the cost of acquiring the blocks of cancellable accident and health policies was deductible.

On appeal, taxpayer presents three issues: (1) Whether unpaid premiums[3] and, a fortiori, loading portions thereof are not assets of a life insurance company; (2) Whether unpaid premiums are included in a life insurance company's underwriting income; and (3) Whether purchased blocks of cancellable accident and health insurance policies are wasting assets, the costs of which may be amortizable over their useful lives.

I.

Taxpayer contends that unpaid premiums and, a fortiori, the loading portions thereof, are not assets of a life insurance company, and accordingly should not be considered assets includable under 26 U.S.C.A. § 805. Taxpayer argues that previous cases have erroneously held that because unpaid premiums are included in *reserves*, giving rise to a *liability*, such premiums must also be included as an *asset* in computing a life insurance company's taxable investment income. Taxpayer recognizes authority contrary to its position, e.g. Franklin Life Insurance Company v. United States, 399 F.2d 757 (7th Cir. 1968), cert denied 393 U.S. 1118 (1969), Jefferson

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[3] Hereinafter, unless otherwise specifically noted, "unpaid premiums" will designate deferred and uncollected premiums and due and unpaid premiums.

Standard Life Insurance Company v. United States, 408 F.2d 842 (4th Cir. 1969), cert. denied 396 U.S. 828 (1969), Western National Life Insurance Company of Texas v. Commissioner of Internal Revenue, 432 F.2d 298 (5th Cir. 1970), and Western & Southern Life Insurance Company v. Commissioner of Internal Revenue, 460 F.2d 8 (6th Cir. 1972), cert. denied 409 U.S. 1063 (1972). Taxpayer argues that these decisions are in error because "courts have uniformly overlooked or failed to give sufficient thought to the fact a company cannot be required to include as assets funds which it does not have."

Taxpayer persuasively contends that although it is obligated to establish reserves for each of its policies, and that the reserves actually exist as a liability, the unpaid premiums do not exist until actually paid. Taxpayer pointedly observes that while the law requires the reserves, it does not require the payment of the premiums which generate the reserves.

The Commissioner of Internal Revenue (Commissioner) contends that the "Tax Court's determination that such premiums [unpaid] must be included in full in the company's "assets" for the purposes of computing its "taxable investment income" under Sections 804 and 805—and must similarly be taken into account in full, without offset or deduction for the loading thereon, in calculating gross premiums for the purpose of computing the company's "gain from operations" under Section 809, "is in accord with the pertinent Treasury Regulations and also with the decisions of the four courts of appeal that

have previously considered the questions presented herein."

In considering the cases supportive of the Commissioner's position, and recognized by taxpayer, *supra*, it is significant, we believe, that one of those courts acknowledged that declaring unpaid premiums to be assets was a fiction:

> The assumption that the annual premium has been received in full is, of course, a fiction, since annual premiums on all policies have not been received as of the end of the taxable year; rather, a portion thereof remains deferred and uncollected. [It being stipulated in our immediate case that there is no obligation, legal or otherwise, on an insured to pay—unpaid premiums.] Franklin Life Insurance Company, supra, 399 F.2d at 760-761.

It is abundantly clear that the other three courts concentrated on *uniformity in accounting for reserves* (which are required by state law) *and in accounting for unpaid premiums* (which the Commissioner contends must be considered in determining the income tax due) in upholding the imposition of higher taxes for the insurance companies involved, irrespective of the fact that they did not realize additional income:

> Thus, if taxpayer treats its reserve liabilities for tax purposes with a full year's net valuation —it should be required to include gross annual premiums . . .
>
> Jefferson Standard Life Insurance Co., supra, 408 F.2d at 856.

> We agree with the other two courts that once the accrual method is used [as for reserves as required by state law] it must be applied uniformly [to unpaid premiums] even though the result would be that the asset figure resulting from applying the accrual basis to the gross premiums would not balance with the policyholders' share of the "net valuation premiums" [giving rise to an inflated asset figure].
>
> Western National Life Insurance Company of Texas, supra, 432 F.2d at 301.
>
> Thus, if potential liability is to be accrued, [reserves as required by state law] we conclude that potential profitability [assets under the pertinent federal tax laws] must also be accrued. Western and Southern Life Insurance Company, supra, 460 F.2d at 10.

We are not persuaded that the decisions relied upon by the Commissioner are controlling. They are predicated on a fiction and a desire to achieve accounting uniformity. No distinction is accorded the fact that reserves are mandated by state law for the protection of the insured, whereas income taxes are, uniformly, owing on *income actually earned.* We do not impute to Congress the intention to impose an income tax burden in any instant when income is not realized. "Potential profitability" should not give rise to a tax.

The Commissioner contends that since the applicable Treasury Regulation, 1.805-5(a)(4)(ii) includes unpaid premiums as assets, and that since this regulation is "plainly within the applicable provisions of the code", it must be enforced. We disagree.

We have no argument with the Commissioner's contention that Treasury Regulations "must be sustained unless they are unreasonable or inconsistent with the underlying statute", citing to Commissioner of Internal Revenue v. South Texas Lumber Company, 333 U.S. 496 (1948). It is by reason of this rule that we hold that Treasury Regulation 1.805-5 (a)(4)(ii) is void insofar as it includes unpaid premiums within assets.

Section 805(b)(4) defines assets:

> (4) Assets. For purposes of this part, the term "assets" *means all assets of the company* (including non-admitted assets), other than real and personal property (excluding money) *used by it in carrying on an insurance trade or business.* For purposes of this paragraph, the amount attributable to—
>
> (A) real property and stock shall be the fair market thereof, and
>
> (B) any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition.
>
> (Emphasis supplied).

Regulation 1.805-5(a)(4)(ii) expands upon the items included within assets:

(ii) *Illustration of principles.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). Included in the statement of P., a life insurance company, are the following items: Bonds; stock; mortgages;—premiums deferred and uncollected and premiums due and unpaid, bank deposits,—.

Assets under Section 805(b)(4) includes "all assets of the company—used by it in carrying on an insurance trade or business." Under Section 805(b)(4)(B) the value of "any other asset" [exclusive of real property and stock set forth under Section 805(b)(4)(A)] shall be its "adjusted basis". Since the Commissioner has stipulated throughout[4] that taxpayer has no legal, enforceable right to collect any unpaid premiums, it is, as we view it, obvious that unpaid premiums are not "assets used by a company in carrying on a trade or business" and that they cannot have any viable "asset" basis until collected. We see no merit in attributing an artificial meaning to the word "asset" absent strong (and for our part, overwhelming) policy reasons for doing so. See Realty Loan Corporation v. Commissioner of Internal Revenue, 478 F.2d 1049 (9th Cir. 1973).

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[4] The tenth stipulation provides:

There is no obligation, legal or otherwise on an insured to pay to the insurer deferred & uncollected or due and unpaid premiums. If the policyholder does not pay the premium in conformity with the provisions of the policy, the policy is lapsed after the grace period and appropriate adjustments are made.

We hold that the regulation exceeds the scope of its statutory genesis. United States v. Correll, 389 U.S. 299 (1967). We hold it void insofar as it includes unpaid premiums as referred to herein (see footnote 3). We are comforted somewhat in the knowledge that our view was previously held by the Tax Court, which has vacillated considerably on this issue:

> —only resort to medieval metaphysics could translate the items in question [deferred and uncollected premiums] into "assets".
>
> Western National Life Insurance Company of Texas v. Commissioner, May 13, 1968.

The Commissioner further contends that since reserves must be accrued, unpaid premiums must likewise be accrued. We disagree. We have previously observed that reserves are set aside for the protection of the insured. Reserves are not discretionary. They are mandated by state insurance commissions. Income tax, on the other hand, is to be paid for income earned, when it is earned. We will not adopt the Commissioner's argument that "accounting symmetry" is necessary when, in doing so, we would endorse the imposition of income taxes before income has actually been earned. This we shall not do. Cf. Colorado Springs National Bank v. United States, 505 F.2d 1185 (10th Cir. 1974), wherein we held that compulsory accounting rules of a regulatory agency do not control tax consequences. For a similar holding see Mountain Fuel Supply Company v. United States, 449 F.2d 816 (10th Cir. 1971).

Applying the Commissioner's contentions and proposition to several other businesses, in our judgment, lays bare its fallacies. Under the Commissioner's theory a landlord, having entered into a one year lease, which included the right of either party to terminate upon thirty days notice, would have an asset for all the unpaid rentals, and an asset to be considered in determining the income tax to be paid by the landlord, even though the landlord has no guarantee of receiving all of the rental payments. Further pursuing the Commissioner's theory, a bank or any other business entity should consider its contingent accounts receivable, in which it has no legally enforceable right, as income for income tax purposes.

The burden is, of course, always on the taxpayer to establish that he is entitled to a particular deduction or refund. Lockhart Leasing Company v. United States, 446 F.2d 269 (10th Cir. 1971); Kasishke v. United States, 426 F.2d 429 (10th Cir. 1970); Harper Oil Company v. United States, 425 F.2d 1335 (10th Cir. 1970). And determinations of the Tax Court must be sustained if evidence is present to support them. Hayutin v. Commissioner of Internal Revenue, 508 F.2d 462 (10th Cir. 1974).

In light of the facts of this case, we hold that the taxpayer has met its burden and that the determinations of the Tax Court cannot be sustained. In Kansas Sand and Concrete, Inc. v. Commissioner of Internal Revenue, 462 F.2d 805 (10th Cir. 1972), we noted that which we deem applicable here:

> In passing we are compelled to observe that in this case the taxpayer proceeded in all good faith. We are cognizant of the difficulties confronting officials charged with the obligation of drafting tax regulations interpretive of and construing the complexities of the Internal Revenue Code. The conflicts presented in this case might well have been avoided had the administrative drafters raised at least one or more "red flags"—. Any taxpayer, we believe, is entitled to this much guidance and consideration.
>
> 462 F.2d at 808.

II.

Taxpayer also contends that unpaid premiums should not be considered part of premium income under Section 809(c)(1). We agree. For similar reasons already discussed in "I" relative to assets, "Premium income" cannot extend to unpaid premiums in which a taxpayer has no legally enforceable right. On a parallel vein, regulation 1.809-4(a)(1)(i) cannot extend to unpaid premiums in which a taxpayer does not have a legally enforceable right. We will not allow income taxes to be assessed on "potential profitability."

III.

Taxpayer contends that it should have been allowed to amortize blocks of cancellable accident and health insurance as wasting assets. Taxpayer cites Union Bankers Insurance Co. v. Commissioner, 64 T.C. No. 78 (August 6, 1975), for the proposition

that such blocks of insurance may be amortized over a given period of time. We agree.

However, in *Union Bankers* an actuary expert testified on behalf of the taxpayer affording background and expertise for the Court's benefit determinative of a definite amortizable time period. Contrary thereto, in the case at bar, the evidence simply [by stipulation] established when the blocks were acquired along with the premiums received and claims paid over a ten year schedule. Such evidence, in and of itself, does not meet the standard of *Union Bankers* in which the amortization period was established. We hold that the proof relative to any specific amortization period was inadequate and, notwithstanding the propriety and applicability of *Union Bankers* within the proper factual situation, taxpayer was not entitled to amortize its blocks of cancellable accident and health insurance policies. The Tax Court properly denied these deductions.

Reversed in part and affirmed in part.

McWILLIAMS, Circuit Judge, dissenting:

I dissent as to parts I and II in the majority opinion. The precise matter at issue in parts I and II has been considered by four other Circuits, and in each instance such Circuit has reached a conclusion contrary to the result reached by the majority in the instant case. I am persuaded that the result reached by the Fourth, Fifth, Sixth and Seventh Circuits is the proper one. *See* Western and Southern Life Insurance Company v. Commissioner, 460 F.2d 8 (6th

Cir. 1972), *cert denied*, 409 U.S. 1063 (1972); Western National Life Insurance Co. of Texas v. Commissioner, 432 F.2d 298 (5th Cir. 1970); Jefferson Standard Life Insurance Co. v. United States, 408 F.2d 842 (4th Cir. 1969), *cert. denied*, 396 U.S. 828 (1969); and Franklin Life Insurance Company v. United States, 399 F.2d 757 (7th Cir. 1968), *cert. denied*, 393 U.S. 1118 (1969).

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

SEPTEMBER TERM—NOVEMBER 6, 1975

Before The Honorable William J. Holloway, Jr., The Honorable Robert H. McWilliams and The Honorable James E. Barrett, Circuit Judges

No. 75-1075
(Tax Ct. No. 4132-71)

STANDARD LIFE AND ACCIDENT INSURANCE COMPANY,
PETITIONER-APPELLANT

vs.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

This cause came on to be heard on the record on appeal from the United States Tax Court, and was argued by counsel.

Upon consideration whereof, it is ordered that the judgment of that court is reversed in so far as it upheld the Commissioner's ruling that deferred and uncollected, and due and unpaid premiums must be included under Section 805 as assets and that none of said premiums may be deducted in determining gain from operations under Section 809. The judgment of the Tax Court in disallowing amortization of appellant's block of cancellable accident and health insurance policies is affirmed.

The cause is remanded to the United States Tax Court for further proceedings in accordance with the opinion of this Court. McWilliams, Circuit Judge, dissents.

/s/ Howard K. Phillips
HOWARD K. PHILLIPS
Clerk

A true copy

Teste
HOWARD K. PHILLIPS
Clerk, U. S. Court of Appeals
Tenth Circuit

/s/ Mary A. Sherman
Deputy Clerk

APPENDIX D

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

NOVEMBER TERM—JANUARY 9, 1976

Before The Honorable David T. Lewis, Chief Judge, The Honorable Delmas C. Hill, The Honorable Oliver Seth, The Honorable William J. Holloway, Jr., The Honorable Robert H. McWilliams, The Honorable James E. Barrett, and The Honorable William E. Doyle, Circuit Judges

No. 75-1075

STANDARD LIFE AND ACCIDENT INSURANCE COMPANY,
PETITIONER-APPELLANT

vs.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

This matter comes on for consideration of the petition for rehearing with suggestion for rehearing en banc which was filed by the appellee in the captioned cause.

Upon consideration whereof, it is ordered that the petition for rehearing is denied by Circuit Judges Holloway and Barrett. Judge McWilliams would grant rehearing.

The petition for rehearing having been denied by the original panel to whom the case was submitted, and no member of the panel nor judge in regular

active service on the Court having requested that the Court be polled on rehearing en banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing en banc is denied.

/s/ Howard K. Phillips
HOWARD K. PHILLIPS
Clerk

A true copy

Teste
HOWARD K. PHILLIPS
Clerk, U. S. Court of Appeals
Tenth Circuit

/s/ Mary A. Sherman
Deputy Clerk

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C. (1958 ed., Supp. II)):

SEC. 801 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112]. DEFINITION OF LIFE INSURANCE COMPANY.

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(b) *Life Insurance Reserves Defined.*—

(1) *In general.*—For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) *Reserves must be required by law.*—Except—

(A) in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation,

(B) in the case of policies issued by an organization which meets the requirements of section 501(c)(9) other than the requirement of subparagraph (B) thereof, and

(C) as provided in paragraph (3),

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

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SEC. 802 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. TAX IMPOSED.

(a) *Tax Imposed.*—

(1) *In General.*—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11(b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

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(b) *Life Insurance Company Taxable Income Defined.*—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the

gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

SEC. 804 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. TAXABLE INVESTMENT INCOME.

(a) *In General.*—

(1) *Exclusion of policyholders' share of investment yield.*—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) *Taxable investment income defined.*—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the

life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equals 100 percent.

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(b) *Gross Investment Income.*—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) *Interest, etc.*—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

(B) the entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company derives interest, rents, or royalties, and

(C) the alteration or termination of any instrument or agreement described in subparagraph (B).

(2) *Short-term capital gain.*—In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss.

(3) *Trade or business income.*—The gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the life insurance company is a partner. In computing gross income under this paragraph, there shall be excluded any item described in paragraph (1).

Except as provided in paragraph (2), in computing gross investment income under this subsection, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.* — Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is the greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year, reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

(2) *Real estate expenses.*—The amount of taxes (as provided in section 164), and other expenses, for the taxable year exclusively on or with respect to the real estate owned by the company. No deduction

shall be allowed under this paragraph for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property.

(3) *Depreciation.*—The deduction allowed by section 167. The deduction under this paragraph and paragraph (2) on account of any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this sentence) as the rental value of the space not so occupied bears to the rental value of the entire property.

(4) *Depletion.*—The deduction allowed by section 611 (relating to depletion).

(5) *Trade or business deductions.*—The deductions allowed by this subtitle (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner; except that in computing the deduction under this paragraph—

(A) There shall be excluded losses—

(i) from (or considered as from) sales or exchanges of capital assets,

(ii) from sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(iii) from the compulsory or involuntary conversion (as a result of

destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(B) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account.

(C) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in part VIII of subchapter B, shall not be allowed.

SEC. 805 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) *In General.*—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) *Adjusted Reserves Rate and Earnings Rates.*—

(1) *Adjusted reserves rate.*—For purposes of this part, the adjusted reserves

rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) *Current earnings rate.*—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) *Average earnings rate.*—

(A) *In general.*—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(B) *Special rules.*—For purposes of subparagraph (A)—

(i) the current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if this part (as in effect for 1958) and section 381(c)(22) applied to such taxable year, and

(ii) the current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company) shall be determined as if this part applied to such company for such year.

(4) *Assets.*—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. For purposes of this paragraph, the amount attributable to—

(A) real property and stock shall be the fair market value thereof, and

(B) any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition.

(c) *Adjusted Life Insurance Reserves.*—

(1) *Adjusted life insurance reserves defined.*—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate

of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rate.

(2) *Average interest rate assumed.*—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

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SEC. 809 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. IN GENERAL.

(a) *Exclusion of Share of Investment Yield Set Aside for Policyholders*—

(1) *Amount.*—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set

aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(2) *Required interest.*—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) *Gain and Loss From Operations.*—

(1) *Gain from operations defined.*—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

(2) *Loss from operations defined.*—For purposes of this part, the term "loss from

operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

(3) *Life insurance company's share.*—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

(4) *Exception.*—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(c) *Gross Amount.*—For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) *Premiums.*—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) *Decreases in certain reserves.*—Each net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

(3) *Other amounts.*—All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the

sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(1) *Death benefits, etc.*—All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) *Increases in certain reserves.*—The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

(3) *Dividends to policyholders.*—The deduction for dividends to policyholders (determined under section 811(b)).

(4) *Operations loss deduction:*—The operations loss deduction (determined under section 812).

(5) *Certain nonparticipating contracts.*—An amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means

such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

(6) *Group life, accident, and health insurance.*—An amount equal to 2 percent of the premiums for the taxable year attributable to group life insurance contracts and group accident and health insurance contracts. The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts.

(7) *Assumption by another person of liabilities under insurance, etc., contracts.*—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(8) *Tax-exempt interest, dividends, etc.*—

(A) *Life insurance company's share.*—Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially

tax-exempt interest provided by section 242 (as modified by section 804 (a)(3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

(B) *Application of Section 246(b).*—In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A)(iii), the limit on the aggregate amount of the deductions allowed by sections 243 (a), 244, and 245 shall be 85 percent of the gain from operations computed without regard to—

(i) the deductions provided by paragraphs (3), (5), and 6 of this subsection,

(ii) the operations loss deduction provided by section 812, and

(iii) the deductions allowed by sections 243(a), 244, and 245,

but such limit shall not apply for any taxable year for which there is a loss from operations.

(9) *Investment expenses, etc.*—Investment expenses to the extent not allowed as a deduction under section 804(c)(1) in

computing investment yield, and the amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income.

(10) *Small business deduction.*—A small business deduction in an amount equal to the amount determined under section 804 (a)(4).

(11) *Certain mutualization distributions.*—The amount of distributions to shareholders made in 1958 and 1959 in acquisition of stock pursuant to a plan of mutualization adopted before January 1, 1958.

(12) *Other deductions.*—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

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SEC. 810 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. RULES FOR CERTAIN RESERVES.

(a) *Adjustment for Decrease.*—If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the excess shall be taken into account as a net decrease referred to in section 809(c)(2).

(b) *Adjustment for Increase.*—If the sum of the items described in subsection (c) as of the

close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2).

(c) *Items Taken Into Account.*—The items referred to in subsections (a) and (b) are as follows:

(1) The life insurance reserves (as defined in section 801(b)).

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2).

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

(5) Premiums received in advance, and liabilities for premium deposit funds.

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SEC. 818 [as added by Sec. 2(a), Life Insurance Company Income Tax Act of 1959, *supra*]. ACCOUNTING PROVISIONS.

(a) *Method of Accounting.*—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

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(f) *Denial of Double Deductions.*—Nothing in this part shall permit the same item to be deducted more than once under subpart B and once under subpart C.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.801-4 *Life insurance reserves.*

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(f) *Adjustments to life insurance reserves.* In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year,

appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

§ 1.805-5 *Adjusted reserves rate and earnings rates.*

(a) *In general.* * * *

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(4) *Assets*—(i) *Definition.* Section 805 (b)(4) defines the term "assets" as meaning all assets of the life insurance company (including nonadmitted assets), other than real and personal property (excluding money) used by the life insurance company in carrying on an insurance trade or business. For purposes of the preceding sentence, the term "money" includes cash, currency, bank deposits (including time deposits) whether or not interest bearing, share accounts in savings and loan associations, checks (whether or not certified), drafts, money orders, and any other item of similar nature. * * *

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(ii) *Illustration of principles.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds, stocks,

mortgages, home office and branch office buildings owned and wholly occupied by the company, furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations. For purposes of section 805(b)(4) and this subparagraph, the home office and branch office buildings owned and wholly occupied by the company, and the furniture and equipment owned by the company and used by it in connection with the operations conducted in the home office and branch office buildings occupied by the company, shall be excluded from the term "assets" since such items are the only ones considered as being used by P in carrying on an insurance trade or business. Accordingly, since bonds, stocks, mortgages, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations are not considered as being used by P in carrying on an insurance trade or business, they are included within the term "assets" and, therefore, shall be taken into account by P in determining its current earnings rate.

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§ 1.809-4 *Gross amount.*

(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809(a)(1) paragraph (c) of § 1.809-2), * * *. The additional three categories of items taken into account are:

(1) *Premiums.* (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid,

deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of § 1.809-5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701 (a)(20)).

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